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IN THE

Supreme Court of the United States

October Term, 1998

ACM PARTNERSHIP,
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari To the United States Court of Appeals For the Third Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

The Brief In Opposition substitutes pejoratives for analysis. But, as this Court ruled in *Cottage Savings*, the Commissioner cannot prevail merely by calling a transaction a "tax avoidance scheme" or by labeling it a "sham." *See* Brief In Opp. at 15,17. Where, as here, a transaction comports with the substantive requirements of the Internal Revenue Code and Treasury Regulations, it must be accorded the tax treatment prescribed by those provisions – without regard to the taxpayer's motivation or the transaction's effect on the taxpayer's economic position. The *ad hoc* equitable inquiry that the Commissioner advocates and the Third Circuit endorsed not only conflicts with *Cottage Savings*, but also lacks any foundation in the relevant statutory and regulatory text. As demonstrated below, each of the Commissioner's attempts to paper over these problems is without merit.

I. ACM's Loss Is "Bona Fide" Within The Meaning Of The Code And The Regulations.

In an effort to legitimate the Third Circuit's "smell test" (Pet. App. at 71a (McKee, J., dissenting)), the Commissioner pretends that the court's free-floating, extrastatutory inquiry – whether a transaction has an appreciable "non-tax economic effect" or a "subjective non-tax purpose" – can be given a home in the regulations implementing § 165 of the Internal Revenue Code. To this end, the Commissioner claims that ACM's loss should be disallowed because it is not "bona fide" within the meaning of Treas. Reg. § 1.165-1(b) – an argument which did not form the basis of the Third Circuit's opinion. This argument is flawed for at least four reasons.

A. ACM's Loss Is A Foreseeable And Intended Result Of The Ratable Basis Recovery Rule. The Secretary anticipated when he promulgated the regulations pursuant to § 453 that the ratable basis recovery rule would produce a "distortion" in the recognition of gain and loss in every contingent payment installment sale where the payments themselves do not turn out to be ratable. Temp. Treas. Reg. § 15a.453-1(c)(7). The regulations under § 453 were written with the expectation they would often result in the reporting of taxable gain in excess of actual economic gain during the early part of the payment period.[1] The regulations explicitly recognize that such "paper" gain would be offset in later years by an equally artificial loss.[2] The offsetting loss merely accounts for the overreporting of taxable gain in earlier years; both the gain and the loss are creatures of the Commissioner's own

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[1] In ACM's case, the regulations required the reporting of taxable gain of $110,749,239 in 1989, and the reporting of a partially offsetting taxable loss of $84,997,111 in 1991. Pet. App. at 23a, 26a.

[2] *See* Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (setting forth rules for recognizing loss "[i]f in any taxable year no payment is received or the amount of the payment received . . . is less than the basis allocated to that taxable year.")

regulation.[3] The notion that a loss intended to offset the overreporting of taxable gain can be disallowed because it is not "bona fide" is plainly wrong.

B. The Commissioner's Position Ignores The Framework Of Partnership Taxation. The Commissioner's suggestion that ACM's reporting of the installment sale transaction was improper disregards the entire framework of partnership taxation, which treats the partnership as a discrete tax reporting entity in which its partners have basis. The Internal Revenue Code determines the taxable income or loss of the partnership and separately determines the tax liability of the partners. The Internal Revenue Code expressly contemplates that a partnership's basis in its assets may differ from the partners' bases in their partnership interests. These differences sometimes produce results that may either advantage or disadvantage the taxpayer in a given tax period. But that does not give the Commissioner carte blanche to disregard the consequences as not "bona fide" when they favor the taxpayer.

In any case, when these rules are applied to ACM's partners over the life of their respective partnership interests, any apparent anomalies disappear. When Kannex recognized a large taxable gain in the first year of the installment sale, Kannex's basis in its partnership interest in ACM increased correspondingly. When Kannex disposed of its interest in ACM, it recognized a taxable loss equal to the excess of its basis, as adjusted for the installment sale gain, over the amount it received on the disposition. In other words, the gain generated by the § 453 regulations was directly offset by

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[3] The Commissioner's brief below includes an example precisely illustrating that the ratable basis recovery rule is intended to work as it did in this case. In the Commissioner's example, a taxpayer sold an asset with a basis of $100 for $99 in cash and a contingent note with a present value of $1. The example confirmed that "the taxpayer reports taxable 'gain' of $79 during the first year" and "an offsetting 'loss' of $79" in the later period. Brief for the Appellee/Cross-Appellant (3d Cir.) at 27.

the loss recognized by Kannex when it disposed of its interest in ACM. This result is the intended operation of the rules of partnership taxation in the Internal Revenue Code.[4] The same rules apply to ACM's other partners and produce equivalent results. In the case of Colgate, for example, the loss recognized by ACM on the sale of the LIBOR Notes, which was allocated to Colgate, reduced Colgate's basis in its partnership interest in ACM. Thus, Colgate's loss is not permanent, just as Kannex's gain was not permanent. Rather, it is preserved in Colgate's basis in its partnership interest. In other words, the "bifurcation" of ACM's gains and losses that so troubles the Commissioner, Brief In Opp. at 15, is nothing more than the proper operation of his own partnership rules.

C. The Tax Status Of Kannex Is Irrelevant. There is no suggestion in § 453 or elsewhere in the Internal Revenue Code that the application of the ratable basis recovery rule is conditioned upon the tax status of the parties involved. Nonetheless, the Commissioner has taken exactly that approach, disallowing ACM's installment sale reporting because Kannex was not subject to U.S. tax, but respecting the installment sale reporting of an analogous transaction in *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325, 1998 Tax Ct. Memo LEXIS 303 (1998). In that case, a partnership engaged in a contingent payment installment sale transaction similar to ACM's transaction. In *ASA Investerings*, however, the court ruled that the entity not subject to U.S. taxation – an entity similar to Kannex – was not a partner in the partnership. All of the partnership's taxable gain and loss was therefore allocated to the other partners. In a joint computation of tax liability submitted following the court's opinion, the Commissioner agreed that the U.S. taxpayer partners would be allocated accelerated gain

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[4] *See* § 705(a) (requiring that a partner's basis in its partnership interest be adjusted by the partner's distributive share of the partnership's gains and losses); § 741 (requiring a partner to recognize gain and loss upon the sale or exchange of a partnership interest).

and then deferred loss. In other words, the same gain and loss that the Commissioner here terms not "bona fide" are exactly the gain and loss that the Commissioner recognized in *ASA Investerings*.[5]

D. The Commissioner's Position Is Inconsistent With Many Other Internal Revenue Code Provisions. Gains and losses are frequently recognized for tax purposes in amounts and at times that do not correspond to the measurement of gains and losses for other purposes. Under the Commissioner's theory, all such tax losses would apparently be disallowed as not "bona fide": these gains and losses are indistinguishable from those created by the ratable basis recovery rule. The Commissioner's position thus contravenes the many provisions of the Internal Revenue Code that explicitly contemplate such losses.

The Internal Revenue Code's measurement of income, gains, and losses frequently diverges from economic reality. It does so for many reasons, including the practical need for an annual accounting period, the difficult question of when taxpayers should be taxed on changes in their economic condition (the concepts of "realization" and "recognition"), considerations of administrative simplicity, and Congress' use of the tax law to encourage or discourage particular behavior. These considerations are evident not just in the ratable basis recovery rule; they are found throughout the Internal Revenue Code and result in many examples of gains and losses that the Commissioner would characterize as not "bona fide."[6] The Commissioner's position cannot be reconciled with these provisions.

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[5] Furthermore, the example in the Commissioner's brief below, discussed in note 3, *supra*, does not claim that the loss offsetting the earlier accelerated gain is not "bona fide," presumably because the unidentified taxpayer was assumed to be subject to U.S. taxation.

[6] *See, e.g.*, § 72(b)(1) (requiring ratable return of capital on annuitized payments); § 168 (establishing fixed depreciation schedules for various classes of assets); § 197 (requiring 15-year amortization of intangibles).

For example, such losses (or gains) can arise when an entity acquires an asset that declines (or increases) in value and new shareholders or partners subsequently purchase an interest in that entity. The new shareholders or partners are entitled to their share of the entity's built-in taxable loss (or gain) – represented by the difference between the entity's basis in the asset and the price paid – if the entity disposes of the asset at its new lower (or higher) value. This loss (or gain) does not decrease (or increase) the wealth of the new shareholders or partners because they paid fair market value for their share of the assets after the assets' value had changed. Certain provisions of the Internal Revenue Code – § 338 for corporations and § 754 for partnerships – give taxpayers the option of adjusting the entity's basis in its assets to eliminate those losses (or gains). The Commissioner's refusal to recognize noneconomic losses would effectively amend those sections by making their option mandatory, and not elective, whenever an entity's basis in its assets exceeds their economic value.

What makes these losses, as well as those under the ratable basis recovery rule, "bona fide" is that they are specifically provided for in the Internal Revenue Code and the regulations promulgated thereunder. The government's position thus collides with the "elementary canon of construction that a statute should be interpreted so as not to render one part inoperative." *Colautti v. Franklin*, 439 U.S. 379, 392 (1979).

II. The Decision Below Conflicts With *Cottage Savings*.

The Commissioner seeks to dismiss the conflict between *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), and the decision below by arguing that the loss in *Cottage Savings* was bona fide, whereas the loss here was not. Brief In Opp. at 16. But, in fact, the loss in both cases was bona fide, and for the same reason. In each case, the taxpayer experienced a material change in its ownership of assets, thereby satisfying the Internal Revenue Code's requirement for a transaction to qualify as a sale or exchange. In *Cottage Savings*, this Court held a loss could be recognized when the

taxpayer exchanged one pool of mortgages for a different pool of mortgages. In this case, the taxpayer exchanged its Citicorp Notes for cash and LIBOR Notes. This Court made clear in *Cottage Savings* that other considerations relied upon by the Third Circuit in this case – such as whether the transaction was motivated by tax considerations and whether it had a nontax economic effect – are simply irrelevant in determining whether a loss should be allowed.

Under the Third Circuit's test, the government, not the taxpayer, would have prevailed in *Cottage Savings*. That transaction served no nontax business purpose and had no objective or subjective prospect for profit. After the mortgage swap, the taxpayer in *Cottage Savings* owned a pool of mortgages having the same term, the same aggregate principal amount, and the same interest rates as the pool of mortgages that it had owned at the beginning of the day. Aside from the taxpayer recognizing a tax loss and incurring transaction costs, the taxpayer experienced no change in its economic position. Thus, the *Cottage Savings* transaction would not meet the Third Circuit's requirement that the transaction have an appreciable "non-tax economic effect" or a "subjective non-tax purpose." If the decision below is allowed to stand, it will constitute an open invitation for the Commissioner to challenge losses on the ground that they arise from transactions motivated solely by tax considerations or without nontax economic effect – arguments expressly rejected by this Court in *Cottage Savings*.

III. It Is Inappropriate For The Judiciary To Rescue The Commissioner From The Consequences Of His Own Rules.

The Commissioner is obviously unhappy with the application of the § 453 regulations to ACM's transaction. But that is hardly a justification for seeking judicial relief from the effect of those regulations.

As the Executive Branch itself plainly understands, the proper forum in which to seek a change in the law is

Congress. In his fiscal year 2000 budget proposals, released just this month, the President asks Congress to enact two measures that would alter the results that the Commissioner finds troublesome in this case and that would achieve through statutory change the outcome the court below imposed without any statutory basis. First, the President urges Congress to authorize the Secretary of the Treasury to disallow tax losses whenever he concludes that the taxpayer has engaged in a "tax avoidance transaction," defined as:

> any transaction in which the reasonably expected pre-tax profit . . . of the transaction is insignificant relative to the reasonably expected net tax benefits . . . of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.[7]

The President's budget also addresses "corporate tax shelters" that involve "tax indifferent parties," – that is, entities not subject to U.S. tax, such as Kannex.[8] The proposal requests that Congress enact a statute requiring either that tax-indifferent parties pay the tax that would otherwise be allocable to them or that the other participants in the transaction be liable for that tax.[9]

These provisions, if enacted, would do precisely what the Commissioner successfully asked the Third Circuit to do:

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[7] Department of the Treasury, *General Explanation Of The Administration's Revenue Proposals* at 96 (February 1999), App. at 1a.

[8] *General Explanation* at 104-05, App. at 3a-5a. *See also* Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government Fiscal Year 2000* at 72 (1999), App. at 6a-8a. Excerpts from the *Budget* and *General Explanation* are included in the Appendix attached hereto.

[9] *General Explanation* at 104-05, App. at 4a-5a. *See also Analytical Perspectives: Budget of the United States Government* at 72, App. at 7a-8a.

empower the Commissioner to alter tax consequences based on his assessment of a taxpayer's motive or prospects for profit, on the balancing of economic and tax consequences, or on the tax status of various parties. Giving the Commissioner such authority would effect a sea change in the tax law. Whether it is wise for Congress to vest such authority in the Executive Branch (and thereby to embroil the Commissioner, taxpayers and the courts in the controversies that would surely follow) is open to question, and whether Congress will grant the Executive Branch that authority is far from certain.[10] The fact remains, however, that a legislative change of this sort is required before the Commissioner may take the position advanced here. As Judge McKee stated in his dissent below, the courts have no authority to give the Commissioner the additional power he seeks. App. 72a.

CONCLUSION

The petition for a writ of certiorari should be granted.

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[10] The budget proposals therefore do not make the issue presented in this case less worthy of this Court's review. Moreover, even in the unlikely event that the proposals were enacted in their current form, the Third Circuit's test would remain relevant to all cases involving prior tax years, which will continue to be litigated for many years to come.

Respectfully submitted,

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General Explanations of the Administration's Revenue Proposals

Department of the Treasury
February 1999

CORPORATE TAX SHELTERS

MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR CORPORATE TAX SHELTERS

* * *

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transactions costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

* * *

DENY CERTAIN TAX BENEFITS TO PERSONS AVOIDING INCOME TAX AS A RESULT OF TAX AVOIDANCE TRANSACTIONS

Current Law

Under section 269, if a person acquires (directly or indirectly) control of a corporation, or a corporation acquires (directly or indirectly) carryover basis property of a corporation not controlled (directly or indirectly) by the

acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, the Secretary may disallow such tax benefit either in whole or in part to the extent necessary to eliminate such evasion or avoidance of income tax. For purposes of this rule, control means the ownership of 50 percent of the corporation's stock (by vote or value). The rule applies also in the case of a qualified stock purchase by one corporation of another corporation, in the event that the acquiring corporation does not elect to treat the stock purchase as an asset acquisition, and where the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date, the principal purpose of which is to secure the benefit of a deduction, credit, or other allowance.

Tax benefits also can be disallowed when those benefits are generated in transactions that lack economic substance and undermine the purposes of the Code. *Sheldon v. Comm'r*, 94 T.C. 738 (1990). Treasury has exercised its general regulatory authority to promulgate anti-avoidance rules in specific contexts, including rules incorporating business purpose and economic substance standards. *See, e.g.*, Treas. Reg. section 1.701-2; Notice 98-5, 1998-3 I.R.B. 3.

Reasons for Change

The Administration is concerned about the proliferation of corporate tax shelter activity that allows a direct or indirect corporate participant to obtain a tax benefit that the participant otherwise did not possess in a tax avoidance transaction. The current law anti-avoidance provision may not be sufficient to address many current corporate tax shelter schemes. First, the provision only applies to the acquisition of control of a corporation or the acquisition of carryover basis property. In addition, although tax evasion or avoidance might be the most significant factor motivating an acquisition or liquidation, it is difficult from an administrative standpoint

to contest a taxpayer's assertion that the transaction had another more significant purpose.

Furthermore, some taxpayers take aggressive positions that they are entitled to a tax benefit even in circumstances in which there is little or no expected pre-tax economic profit from a structure. The proposal would clarify that tax benefits arising from tax avoidance transactions would be disallowed. The Administration proposes to expand the anti-avoidance provision to better address the types of transactions that the Administration believes are abusive.

Proposal

The proposal would expand the scope of the anti-avoidance rule by adding a provision authorizing the Secretary to disallow a deduction, credit, exclusion or other allowance obtained in a tax avoidance transaction. For purposes of this proposal, "tax avoidance transaction" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. No inference is intended regarding the treatment of such transactions under current law.

The proposal would apply to transactions entered into on or after the date of first committee action.

TAX INCOME FROM CORPORATE TAX SHELTERS INVOLVING TAX-INDIFFERENT PARTIES

Current Law

The Federal income tax system has many participants who are indifferent to tax consequences, e.g., foreign persons, tax-exempt organizations, and Native American tribal organizations. Foreign persons are subject to U.S. Federal income tax on a net basis on income that is effectively connected to a U.S. trade or business (ECI) and on a gross basis on income that is fixed or determinable annual or periodic (FDAP). Tax-exempt organizations (including

pension plans and charitable organizations) are subject to Federal income tax only on income that is unrelated (UBTI) to the organization's exempt purpose.

Reasons for Change

Many corporate tax shelters involve a timing mismatch or separation of income or gains from losses or deductions that is exploited through the use of tax indifferent parties. In these transactions, the tax indifferent party absorbs the income or gain generated in the transaction, leaving the corresponding loss or deductions to the taxable corporate participants. Tax indifferent parties often agree to engage in such transaction in exchange for an enhanced return on investment or for an accommodation fee. Corporate taxpayers should not be entitled to buy the special tax status of tax indifferent parties. Imposing a tax on the income allocated to tax indifferent parties should limit the sale of their special tax status and, thus, their participation in corporate tax shelters.

Proposal

The proposal would provide that any income allocable to a tax indifferent party with respect to a corporate tax shelter is taxable to such party. The tax on the income allocable to the tax indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. All other participants of the corporate tax shelter (i.e., any participant other than the tax indifferent party in question) would be jointly and severally liable for the tax. For this purpose, a corporate tax shelter would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. A tax indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be

treated as expiring if the carryforward is more than 3 years old.)

In the case of a tax-exempt organization, the income would be characterized as UBTI. In the case of a domestic corporation with expiring loss or credit carryovers, tax would computed without regard to such losses or credits. In the case of a foreign person, tax on the income or gain allocable to such person would first be determined without regard to any exclusion or exception (provided in a treaty or otherwise) and any such income or gain that is not U.S. source FDAP would be treated as ECI, regardless of its source. If the foreign person properly claimed the benefit of a treaty, however, the tax otherwise owing by such person would be collected from the other participants who are not exempt from U.S. tax. Similarly, in the case of a Native American tribal organization, the tax on the income allocable to such person would be determined without regard to any exclusion or exception; however, the tax would be collected only from the participants who are not exempt from U.S. tax, rather than the tribal organization.

The proposal would be effective for transactions entered into on or after the date of first committee action.

* * *

ANALYTICAL
PERSPECTIVES

Office of the President of the United States
Office of Management and Budget

BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2000

ELIMINATE UNWARRANTED BENEFITS AND ADOPT OTHER REVENUE MEASURES

The President's plan curtails unwarranted corporate tax subsidies, closes tax shelters and other loopholes, improves tax compliance and adopts other revenue measures.

LIMIT BENEFITS OF CORPORATE TAX SHELTER TRANSACTIONS

The Administration is concerned about the proliferation of corporate tax shelters and their effect upon both the corporate tax base and the integrity of the tax system as a whole. The primary goals of corporate tax shelters are to manufacture tax benefits that can be used to offset unrelated income of the taxpayer or to create tax-favored or tax-exempt economic income.

Corporate tax shelters may take several forms but often share certain common characteristics. Corporate tax shelter schemes are often marketed by their designers or promoters to multiple corporate taxpayers. The transactions typically involve arrangements among corporate taxpayers and persons not subject to U.S. tax. Shelters are also often associated with high transactions costs, contingent or refundable fees, unwind clauses, financial accounting treatment that is significantly more favorable than the corresponding tax treatment, and property or transactions unrelated to the corporate participant's core business.

The Administration proposes several general remedies to curb the growth of corporate tax shelters. In addition, the Administration proposes to modify the treatment of certain specific transactions that provide sheltering potential. No inference is intended as to the treatment of any of these trnsactions under current law.

* * *

Deny certain tax benefits in corporate tax shelters.

Under current law, if a person acquires control of a corporation or a corporation acquires carryover basis property of a corporation not controlled by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing certain tax benefits, the Secretary may disallow such benefits to the extent necessary to eliminate such evasion or avoidance of tax. However, this current rule has been interpreted narrowly. The Administration proposes to expand the current rules to authorize the Secretary to disallow a deduction, credit, exclusion, or other allowance obtained in a corporate tax shelter. The proposal would apply to transactions entered into on or after the date of first committee action.

* * *

Tax income from corporate tax shelters involving tax-indifferent parties.

The Federal income tax system has many participants who are indifferent to tax consequences (e.g., foreign persons, tax-exempt organizations, and Native American tribal organizations). Many corporate tax shelters have tax-indifferent participants who absorb taxable income generated by the shelters so that corresponding losses or deductions can be allocated to taxable participants. The proposal would provide that any income received by a tax-indifferent person

with respect to a corporate tax shelter would be taxable. The proposal would be effective for transactions entered into on or after the date of first committee action.

* * *